DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, SB/SE 2
CC:SB:
Attn:

FROM: Paul F. Kugler
Associate Chief Counsel
(Passthroughs and Special Industries) CC:PSI

SUBJECT: Gift Tax Issues

This Chief Counsel Advice responds to your memorandum, dated April 2, 2001, requesting assistance in preparing TL-N-1558-01. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Donor	=
FC	=
B	=
C	=
D	=
XX	=
State 1	=
State 2	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=

Date 7	=
F	=
G	=
H	=
I	=
J	=
K	=
L	=
$ M	=
$ P	=
$ Q	=
R	=
S	=
T	=
U	=
V	=
W	=

ISSUES

(1) Whether Donor’s family corporation, FC, lacks economic substance and should be disregarded for gift tax purposes.

(2) Whether Donor made a gift of the underlying assets of the corporation to the other family shareholders on formation of FC.

(3) Whether Donor made indirect gifts of the underlying assets in FC to the extent of the donees’ proportionate shares of interests in the corporation, within the meaning of Treas. Reg. §25.2511-1(h)(1).

(4) Whether FC should be disregarded as a restriction on the sale or use of the assets contributed by Donor to the corporation, pursuant to section 2703(a)(2).

(5) Whether, in the alternative, restrictions in FC documents or under applicable state law on the sale or use of stock should be disregarded when valuing Donor's intrafamily gifts of FC stock, pursuant to section 2703(a)(2).

(6) Whether restrictions on liquidation in FC documents should be disregarded when valuing FC stock transferred to Donor's family members, pursuant to section 2704(b).

(7) Whether, in the alternative or in addition to all of the above, the combined minority and lack of marketability discounts claimed by Donor with respect to the gifts of FC stock should be allowed.

CONCLUSIONS

(1) If further factual development confirms present indications, we recommend you consider arguing that FC should be disregarded for gift tax purposes because it lacks economic substance.

(2) We do not recommend raising the gift on formation argument in this case.

(3) The facts as developed appear to indicate that Donor made indirect gifts to her children on Date 2 of proportionate shares of the assets transferred to FC . Further factual development is necessary to determine whether to advance an indirect gift argument with respect to Donor's gifts on Dates 3, 4, and 6.

(4) If further factual development confirms that Donor has not satisfied the section 2703(b) safe harbor requirements, we recommend you consider arguing that, pursuant to section 2703(a)(2), FC's corporate form is a restriction on the right to sell or use the underlying assets Donor transferred to the corporation that must be disregarded when valuing Donor's gifts.

(5) If further factual development confirms that Donor has not satisfied the section 2703(b) safe harbor requirements, we recommend you consider arguing that, pursuant to section 2703(a)(2), any restrictions in corporate documents or under applicable state law on the right to sell or use the FC stock Donor transferred by gift must be disregarded when valuing Donor's gifts.

(6) We recommend that you consider arguing that restrictions on liquidation should be ignored pursuant to section 2704(b) when valuing Donor's gifts of FC stock only if further factual development reveals the existence of liquidation provisions in a corporate document that are more restrictive than the applicable state law provisions.

(7) The combined U percent discount for lack of control and lack of marketability claimed by Donor for all transfers of FC stock is excessive. The only corporate assets are publicly-traded, widely-held governmental debt securities. We recommend you consider procuring an expert appraisal to determine any appropriate applicable discounts.

FACTS

Donor lives in State 1. At the age of XX, Donor discussed estate and gift planning with her attorney, including "continuation and expansion of annual gifts as well as advice regarding larger gift with payment of gift taxes to reduce estate tax obligation." Following that discussion and discussions with R, her accountant in State 2, Donor caused articles of incorporation to be filed in State 2 on Date 1 establishing FC, a family corporation. Also on Date 1, Donor transferred to FC cash, 12 tax-free municipal bonds, and two U.S. Treasury Notes, with a combined market value of $ M. In exchange, Donor received F shares, or 100 percent, of the sole class of FC stock.

In addition to providing for the number and positions of directors and officers, the corporate bylaws provide that an annual shareholders' meeting to elect directors and transact "other business" shall be held and that the bylaws may be amended by a majority vote of the shareholders and directors, subject to "the right of the shareholders to change or repeal any By-Laws made or amended by the directors." The FC articles of incorporation state that the purpose of FC is "to enter into any business lawful under the laws of [State 2],"" to engage in any lawful activity for which corporations may be formed under the [law of State 2]," and "to enter upon and engage in any kind of business of any nature whatsoever in any other state."

No shareholders' agreement was executed. The facts as developed indicate that at the initial shareholders' meeting, Donor and her three children, B, C, and D, were appointed to the FC board of directors; Donor, B, C, and D were appointed president, vice-president, secretary and treasurer of FC; and, Donor was authorized to execute an election to tax FC as an "S" corporation, a flow-through entity, for federal tax purposes.[1] Donor and D have signature authority for FC's checking account.

Donor obtained from S an appraisal of the value of a block of FC stock comprising T percent of the outstanding shares as of Date 2. S treated FC as a "going concern business entity," considered FC's assets to be an "integral part of a going-concern business," considered FC's business to be "the investment of cash and marketable securities," and assumed that FC's net income would be retained. S concluded that the value of an T percent block of stock should reflect a combined U percent discount from the market value of the corporation's underlying assets for lack of control and lack of marketability.

[1] Our advice does not address either the ability of FC to elect "S" status or whether the election was valid. We assume, for purposes of discussion, that neither concern is at issue.

Also on Date 2, Donor transferred by gift G FC shares, or T percent of the outstanding shares, to each of her three children--for a total combined gift of W percent of the FC stock.

On Date 3, Donor transferred by gift H FC shares to her three children, to eight grandchildren, and to 4 great-grandchildren.

On Date 4, Donor transferred by gift I shares of FC stock to her three children and a son-in-law, and transferred by gift J shares to six grandchildren and one grandchild's spouse.

As of Date 5, most of the securities transferred to FC had been replaced with U.S. Treasury Notes. Including cash of $ P, the Date 5 market value of the FC brokerage account in which the securities were held was $ Q.

On Date 6, two months after Date 5, Donor transferred by gift K FC shares to her three children and L shares to six grandchildren.

On her gift tax returns for each of the pertinent years, Donor claimed U percent discounts with respect to each of the gifts made on Dates 2, 3, 4, and 6, and claimed an annual gift tax exclusion under section 2503 with respect to each of the gifts. Had the nondiscounted values been used, only the gifts of J shares and L shares on Date 4 and Date 6 would have had values equal to or less than the amount of the section 2503 annual exclusion in effect for the pertinent years. Donor has since disavowed S's appraisal and now relies on an appraisal claiming a combined minority interest and lack of marketability discounts for all gifts in the range of V percent.

The developed facts indicate that a document was executed on Date 7, removing Donor as a director and officer of FC and reducing the number of directors to three. The Date 8 document also stated, after the fact, that shareholders' meetings were held in prior years, but after the initial meeting. No compensation was paid to Donor and her children, as FC's officers, and the corporation had no other employees. FC's accounting and clerical needs were performed by an outside firm.

You have requested an opinion on several potentially applicable arguments in support of proposed gift tax adjustments.

LAW AND ANALYSIS

Background

Use of family limited partnerships, family limited liability corporations, and closely-held corporations as legitimate planning devices has been recognized for several decades. On the other hand, the potential for abusing these entities, i.e., use of these entities merely as devices to escape federal transfer taxes, also has long been recognized. The abuse may occur when family members place assets in a family partnership or family corporation, transfer fractional interests in the entity to other family members, either by gift or inheritance, then claim a substantial discount on the value of those assets on federal gift and/or estate tax returns, usually for lack of control (minority interest) or lack of marketability attributable to the form of the entity, or other restrictions in the entity agreement.

Several recent court opinions have addressed the estate and gift tax consequences of the use of family limited partnerships and family corporations. See, e.g., Estate of Jones v. Commissioner, 116 T.C. 121 (2001); Knight v. Commissioner, 115 T.C. 506 (2000); Estate of Strangi v. Commissioner, 115 T.C. 478 (2000); Shepherd v. Commissioner, 115 T.C. 376 (2000), appeal pending, No. 01-12250-HH (11th Cir. 2001); Kerr v. Commissioner, 113 T.C. 449 (1999), appeal pending, No. 00-60903 (5th Cir. 2001); see also Sather v. Commissioner, 251 F.3d 1168 (8th Cir. 2001), aff'g. T.C. Memo. 1999-29.

We emphasize that in this area, the courts' opinions are in all cases contingent upon the facts and circumstances and, if applicable, the pertinent state laws. Accordingly, we further emphasize that the decision whether to assert a particular argument necessarily must be made on the particular facts of each case.

A. First Inquiry - Identifying the property transferred.

Whether considering the gift tax or the estate tax, the transfer tax statutory regime requires a two-part inquiry. First, the property transferred by gift or the property to be included in a gross estate must be identified. Only when the property transferred has been identified is the second inquiry undertaken, i.e., valuation of the transferred property.

Section 2501 of the Internal Revenue Code imposes a tax on all property transferred by gift. Section 2511(a) provides that the gift tax shall apply whether the gift is in trust or otherwise or direct or indirect, and whether the property is real or personal, tangible or intangible. In the context of family limited partnership or family corporation cases, therefore, the first inquiry turns on whether the property transferred by gift is an interest in either a partnership or a corporation or whether it is, in substance, a gift of an interest in the underlying assets of the entity. Various theories are applicable in identifying the property transferred. The application of any of these approaches is dependent upon the facts of each case.

Issue 1. Whether FC should be disregarded for gift tax purposes because it lacks economic substance.

For more than 50 years, the courts have applied the economic substance doctrine, or a variant thereof, in the income tax context to disregard a diverse mix of transactions and entities that are devoid of economic substance other than the generation of tax benefits. The simple expedient of drawing up papers does not control for tax purposes when the objective economic realities are to the contrary.

See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978); U.S. v. Court Holding Co., 324 U.S. 331, 334 (1945); Commissioner v. Tower, 327 U.S. 280, 291 (1946); Gregory v. Helvering, 293 U.S. 465, 469 (1935); ASA Investments v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000); True v. United States, 190 F.3d 1165 (10th Cir. 1999); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S. Ct. 1251 (1999); Ferguson v. Commissioner, 29 F.3d 98 (2d Cir. 1994); Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989); Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984); Winn-Dixie Stores, Inc. v. Commissioner, ___ F.3d ___ , 2001 U.S. App. LEXIS 14346 (11th Cir., June 28, 2001), aff'g 113 T.C. 254 (1999); Compaq Computer Corporation v. Commissioner, 113 T.C. 214 (1999).

In ACM Partnership, the United States Court of Appeals for the Third Circuit distilled the many economic substance cases into one useful analysis:

> The inquiry into whether the taxpayer's transaction had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions [practical economic consequences, other than the creation of tax benefits] and the 'subjective business motivation' behind them [valid business purpose or profit motive]. . . [T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. [Emphasis added, citations omitted.]

ACM Partnership, 157 F.3d at 247, 248-49, 253-45.

Despite the Tax Court's recent unwillingness to apply the economic substance doctrine in Estate of Strangi v. Commissioner, 115 T.C. 478 (2000), and Knight v. Commissioner, 115 T.C. 506 (2000), the applicability of the doctrine in estate and gift tax cases is well established, just as it is in income tax cases. See Sather v. Commissioner, 251 F.3d 1168 (8th Cir. 2001), aff'g. T.C. Memo. 1999-29 (recharacterizing transfers to brother's children as indirect transfers to donor's children; donors not entitled to gift tax annual exclusions for transfers lacking economic substance); Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991) (transfer to third party with retransfer to son was indirect transfer to son); Schultz v. United States, 493 F.2d 1225, 1226 (4th Cir. 1974) (reciprocal gifts to extended relatives were gifts to each donor's children); Vose v. Commissioner, 284 F.2d 65, 68-69 (1st Cir. 1960) (transfers of certificates of trust indebtedness were outright gifts to recipients, rather than gifts in trust); Estate of Schuler v. Commissioner, T.C. Memo 2000-392 (reciprocal transfers to extended family members were indirect gifts to each donor's children); Estate of Bies v. Commissioner, T.C. Memo. 2000-338 (transfers to daughters-in-law who retransferred to their spouses were indirect gifts to donor's sons); Estate of Cidulka v. Commissioner, T.C. Memo.

1996-149 (same). As the United States Court of Appeals for the Eighth Circuit stated in upholding the Tax Court's application of the reciprocal trust, or reciprocal transaction, doctrine to determine that transfers lacked economic substance for gift tax purposes:

> Substance over form analysis applies equally to gift tax cases. . . . It is impliedly included in the gift tax statute itself – including indirect transfers within the definition of a taxable gift. See Sec. 2511(a). "'The terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense; . . . [they] are designed to cover and comprehend all transactions . . . whereby . . . property or a property right is donatively passed.

Sather, 251 F.3d at 1174 (internal citations omitted).

The application of the economic substance doctrine in transfer tax cases is not limited to determining the true transferor or transferee, but also applies to determine the nature of the property transferred. For example, the Tax Court in Estate of Murphy, T.C. Memo. 1990-472, applied an approach similar to the ACM two-prong analysis, focusing on a decedent's subjective intention and on the objective economic facts to disregard the decedent's transfers of two fractional gifts of stock in a closely-held corporation because she retained effective control of the corporation and the transfers did not appreciably affect her beneficial interests except to reduce transfer taxes. See also Griffin v. United States, 42 F. Supp.2d 700 (W.D. Tex. 1998) (aggregating two transfers and determining no fractional discount applicable in valuing transfer).

Underlying application of the rationale in transfer tax cases is the fact that the genuineness of intrafamily transfers cannot reasonably be inferred from any circumstantial assurances of a business purpose. Estate of Huntington v. Commissioner, 16 F.3d 462 (1st Cir. 1994); Kincaid v. United States, 682 F.2d 1220, 1225 (5th Cir. 1982) (transfers among family members necessitates special scrutiny "precisely because the genuineness of the transaction cannot reasonably be inferred" from statements of business purpose) (quoting Fehrs v. United States, 620 F.2d 255, 260 (Ct. Cl. 1980)); Ginsberg v. Commissioner, 502 F.2d 965, 967 (6th Cir. 1974). As the court noted in Kuney v. Frank, 308 F.2d 719, 720-21 (9th Cir. 1962), these transfers "afford much opportunity for deception."

In Estate of Strangi, a deeply divided Tax Court disregarded the transfer, two months prior to death, of a decedent's stock, real estate, insurance policies, annuities, receivables and other partnership interests into a family limited partnership. The partnership's only activity prior to the decedent's death was the distribution of funds in payment of the decedent's living, medical expenses, and ancillary expenses. After his death, the partnership distributed more than $3,000,000 to his estate for payment of taxes, posted bonds in connection with the federal and state examinations of his estate tax return, and distributed more than $2,500,000 to each of his children. Estate of Strangi, 115 T.C. at 483-86.

The seven-judge majority rejected as unpersuasive all of the alleged business and planning motivations for forming the Strangi limited partnership, indicating that such formation was "mere window dressing to conceal tax motives." The court further found that the decedent, through the son-in-law's power of attorney, retained actual control and the economic benefit of the assets contributed to the partnership. Estate of Strangi, 115 T.C. at 485-86. The majority, nonetheless, declined to apply the economic substance doctrine to disregard the formation of SFLP and Stranco on the basis that to do so "would be equivalent to applying section 2036(a) [which was not in issue] and including the transferred assets in decedent's estate." Id. at 486. Because the state law formalities were followed for the formation of the partnership, the court held that the partnership had sufficient substance to be recognized for tax purposes, regardless of subjective intentions. Id. at 485-87.

The Tax Court gave a more in-depth explanation of its rationale in Knight, a case issued concurrently with Estate of Strangi. In addressing the application of the economic substance doctrine in the gift tax context, the court stated:

> The parties stipulated that the steps followed in the creation of the partnership satisfied all requirements under Texas law, and that the partnership has been a limited partnership under Texas law since it was created. Thus, the transferred interests are interests in a partnership under Texas law. Petitioners have burdened the partnership with restrictions that apparently are valid and enforceable under Texas law. The amount of tax for Federal estate and gift tax purposes is based on the fair market value of the property transferred. See secs. 2502, 2503. The fair market value of property is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs. We apply the willing buyer-willing seller test to value the interests in the partnership that petitioners transferred under Texas law. We do not disregard the partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it.
>
> Respondent relies on several income tax economic substance cases. We disagree that those cases require that we disregard the partnership here because the issue here is what is the value of the gift. See secs. 2501, 2503; sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512- 1, Gift Tax Regs.

Knight, 115 T.C. at 513-14 (internal citations omitted).

We do not agree that merely because state law formalities were followed when a statutory entity such as a family limited partnership or a family corporation was created that sufficient justification exists for concluding that an entity must be recognized for transfer tax purposes.

The Tax Court majority in Knight, in essence, acknowledged the application of substance over form in the transfer tax context, but distinguished that case from transfer tax cases including Heyen, Schultz, Griffin, and Estate of Murphy, when it stated that "we believe the form of the transaction here (the creation of the partnership) would be taken into account by a willing buyer; thus the substance and form of the transaction are not at odds for gift tax valuation purposes." Knight, 115 T.C. at 514.

The determination of whether or not an entity should be respected for transfer tax purposes, however, should be made independently of the willing buyer-willing seller valuation standard. As discussed above, the statutory transfer tax regime requires a two-step inquiry, first the property transferred is identified and only then is the value of the transferred property determined. An approach that utilizes the valuation, or willing buyer-willing seller, standard to dictate the identity of the property interest subject to either the estate or the gift tax is contrary to both the section 2031/2033 statutory estate tax scheme and the section 2501/2511/2512 gift tax scheme.

In the present case, the facts as developed indicate that FC operates no business, functions as a mere conduit for planned family gifting, and was formed for the sole purpose of reducing federal transfer taxes. Donor discussed with her attorney a plan to continue her pattern of transferring assets to her family and reducing future estate taxes. She subsequently transferred cash, tax-free municipal bonds and U.S. Treasury notes to FC, then transferred by gift T percent of her FC shares to each of her three children, which combined constituted a majority of outstanding FC shares. Each year thereafter, Donor has transferred small amounts of her remaining shares by gift to her children, her grandchildren, and her great-grandchildren. Donor claimed an annual gift tax exclusion and a U percent discount from market value with respect to each gift. The parties observed the formalities necessary to create the entity under state law by filing articles of incorporation, writing "bare bones" bylaws, holding an initial shareholders' meeting, and electing to be taxed as an "S" corporation. The facts indicate that FC has conducted no activity beyond the filing of S corporation income tax returns and issuing Schedules K-1 detailing the allocation and distribution of income to shareholders. A document executed after the fact on Date 7 indicates that shareholders' meetings were held in prior years. Further the corporation conducts no business of any sort, pays no salaries to its officers, and has no other employees. It would appear, therefore, that the alleged nontax motive for placing Donor's assets in FC, "centralization of management of assets," is not supported and no active management has been undertaken by FC.

[redacted]

[redacted]

Issue 2. Whether Donor made a gift on formation of FC.

As discussed above, section 2511(a) provides that the gift tax shall apply whether a gift is in trust or otherwise or direct or indirect, and whether the property is real or personal, tangible or intangible. The gift tax is "not imposed upon the receipt of property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned on the ability to identify the donee at the time of the transfer." Treas. Reg. § 25.2511-2(a). Rather, the gift tax is an excise on the donor's act of transfer, "is measured by the value of property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable." Id.

Section 2512(a) and (b) provide that the amount of the gift is the value of the property transferred, and that when property is transferred for less than adequate consideration, the gift is the amount by which the value of the property exceeds the consideration received. A sale, exchange, or other transfer of property may be considered a gift if it is for less than adequate consideration. If it is made in the ordinary course of business in a transaction that is bona fide, at arms' length, and free from any donative intent, however, it will be considered as made for an adequate and full consideration in money or money's worth. Treas. Reg. § 25.2512-8.

The "gift on formation" or "gift on inception" argument is based on the theory that the difference between the value of assets contributed to an entity such as a family limited partnership or family corporation and the value of the interest in the entity received by the transferor constitutes a gift. Thus, the gift on formation argument focuses solely on the transferor's initial transaction and the consideration received by transferor in the initial exchange for her assets, i.e., a partnership interest or corporate stock. This assumes that the transaction is a bona fide sale, and requires an initial determination of whether the consideration received by the transferor (the partnership interest or corporate stock) is "full and adequate consideration in money or money's worth." In addition, the argument does not take into consideration the existence of any transferee or donee.

Many of the facts justifying application of the economic substance doctrine, above, or in determining whether a transfer is an indirect gift, discussed below, would also support a determination that gift was made on formation of a partnership or corporation. This argument, however, is most appropriate as an alternate argument in the context of a gift or estate tax case where it is claimed that the value of partnership or corporate interests to be included in a decedent's gross estate is less than the value of partnership or corporate interests just prior to the making of intrafamily gifts, or that the value of such interests should be discounted from the value of the assets the decedent transferred into the entity on formation. Accordingly, we do not recommend asserting that Donor made a gift on formation of FC.

Issue 3. Whether Donor's gifts of FC stock were indirect gifts of a proportionate share of the underlying assets.

As explained above, the gift tax regime requires a two-part inquiry -- a determination of the property transferred by gift, and then the determination of the value of the transferred property at the date of the gift. See I.R.C. §§ 2501, 2511(a), 2512; Treas. Reg. §§ 25.2511-1, 25.2511-2, 25.2512-1, 25.2512-8. In making the first determination, section 2511(a) provides that the gift tax is imposed on all gifts of property, whether direct or indirect, tangible or intangible, in trust or otherwise. Where property is transferred for less than an adequate and full consideration in money or money's worth, amount by which the value of the property transferred exceeds the value of the consideration is a gift except to the extent the transfer is in the ordinary course of business, i.e., it is bona fide, at arm's length, and free from donative intent. Treas. Reg. § 25.2512-8; Commissioner v. Wemyss, 324 U.S. 303, 306 (1945).

The transfer of assets to a corporation for less than adequate and full consideration generally constitutes an indirect gift from the transferor to the other shareholders. Treas. Reg. § 25.2511-1(h)(1) ("A transfer of property by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation.") Transfers involving family members and their closely held corporations are closely scrutinized to determine whether the transfer is a gift, and such intrafamily transfers are presumed to be gifts. Harwood v. Commissioner, 82 T.C. 239, 258 (1984), aff'd without published opinion, 786 F.2d 1174 (9th Cir. 1986). Thus, as the Eighth Circuit recently recognized in Sather v. Commissioner, 251 F.3d at 1173-75, in the context of purported gifts of stock in family corporations or interests in family partnerships, the taxation of "indirect" gifts pursuant to section 2511 and the regulations thereunder constitutes a statutory embodiment of the economic substance (or form over substance) doctrine, requiring that the first gift tax inquiry focus predominantly on an objective analysis of the parties' economic positions. In making a determination whether an indirect gift of the underlying assets of an entity has been made in intrafamily transfers, a "step-transaction" approach to determining the true effect of the transaction often may be employed.

In Sather, three brothers and their wives, along with one unmarried brother, owned all of the stock in a closely-held family business. In order keep the business in the family and pass it to the next generation, each married brother and his wife transferred, on the same day and in the same amount, shares of stock to trusts for their own children and for their nieces and nephews. The taxpayers claimed annual gift tax exclusions with respect to each transfer to a child, a niece or a nephew. Upholding the Tax Court's application of the reciprocal trust or reciprocal transaction doctrine to determine that the transfers lacked economic substance, the Eighth Circuit held that the transfers to nieces and nephews were indirect, or constructive, transfers to each taxpayer's own children.

The Sather court explained the application of the reciprocal trust doctrine as follows. The reciprocal trust doctrine was first enunciated by the Supreme Court in United States v. Grace, 395 U.S. 316, 324 (1969). In that case, a husband and wife created trusts with reciprocal transfers of life estates in each other's trusts. The Court disregarded the form of the transaction because the multiple, interrelated transactions left the trust settlors in the same economic position as they would have been had they created trusts naming themselves life beneficiaries.

> "[Grace] does not speak in terms of a retained economic interest - - rather, that the arrangement 'leaves the settlors in approximately the same economic position . . .. [Exchange Bank and Trust Co. of Florida v. United States, 694 F.2d 1261, 1268 (Fed. Cir. 1982)]. In this case, the parents transferred stock to their nieces and nephews in exchange for transfers to their own children by the nieces' and nephews' parents. . . . The donors were in the same economic position – the position of passing their assets to their children – by entering the cross-transactions as if they had made direct gifts of all of their stock to their own children. Applying the analysis of the reciprocal trust doctrine, we hold that these interrelated gifts were reciprocal transactions that must be uncrossed to reach the substance of the transactions.

Sather, 251 F.3d at 1174-75.

In other cases, courts have also applied a substance over form analysis in determining that a transferor made indirect gifts of proportionate shares of the underlying assets in a family partnership or corporation. See Shepherd v. Commissioner, 115 T.C. 376 (2000), appeal pending, No. 01-12250-HH (11th Cir. 2001) (where donor executed a partnership agreement and transferred his assets to partnership one day before sons executed partnership agreement, donor made indirect gift of underlying transferred assets to each son proportionate to that son's partnership interest); Estate of Trenchard v. Commissioner, T.C. Memo 1995-121

(1995) (decedent's transfer of farmland, feed, and livestock to family corporation constituted indirect gifts of proportionate shares of such assets to family shareholders, and was not a transfer in ordinary course of business within meaning of Treas. Reg. § 2512-8); see also Heyen, 945 F.2d at 363; Chanin v. United States, 393 F.2d 982, 979-80 (Ct. Cl. 1968) (same); Estate of Shuler, T.C. Memo 2000-392; Estate of Bies, T.C. Memo. 2000-338; Estate of Cidulka, T.C. Memo. 1996-149) (all holding reciprocal transfers to extended family members were indirect gifts to donors' children).

In Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982), the 80-year old taxpayer and her two sons formed a family corporation, each transferring approximately $330 and receiving approximately 3.3 shares of Class A common stock. In addition, the taxpayer transferred her 5700-acre farm to the corporation, receiving in exchange 1,000 shares of Class B common stock and 2400 shares of preferred stock. On the same day, the taxpayer gave to her sons 460 shares of her Class B stock and all 2400 shares of her preferred stock. At the conclusion, the taxpayer owned 34 percent of the Class A stock, 54 percent of the Class B stock and no preferred stock. The Class A stock had a par value of $100, was entitled to dividends only upon vote of the directors, but had exclusive right to vote. The Class B stock had no par value, was entitled to no dividends, and had no right to vote. The preferred stock had a par value of $50, was entitled to receive a noncumulative dividend of 6 percent out of the company's unreserved and unrestricted earned surplus. Upon liquidation, the holders of Class B stock were to receive all corporate assets remaining after payment of the liquidation, or par, values of the preferred stock and the Class A stock.

The court, in effect, looked at the entire transaction, or at the cumulative transfers, to determine the objective economic effect to all parties at the end of the transfers. There was no dispute that the value of the farm was $634,000 on the date it was transferred to the corporation. The court determined that the transfers were all prearranged, and accepted the determination of the jury in the court below (made after hearing expert appraisal testimony) that the value of the Class B common stock was $51.30 per share and the value of the preferred stock was $50.00 per share. Kincaid, 682 F.2d at 1224. Thus, the court first determined that the taxpayer received a total of $171,300.00 in consideration for her contribution of the ranch to the corporation ($50 x 2400 shares preferred + $51.30 x 1000 shares Class B). Applying Treas. Reg. § 25.2511-1(h)(1), the court then held that the taxpayer made indirect gifts of one-third of the remaining value of the farm transferred to the corporation to each of her two sons, each gift proportionate to the one-third interest Class A interest each son owned in the corporation ($634,000 - $171,300 x 0.33). Id. ("Mrs. Kincaid cannot, of course, make a gift to herself, so her transfer of the ranch to the corporation represents a gift to each of her sons").

More recently, the decedent and his wife in Estate of Bosca v. Commissioner, T.C. Memo. 1998-251, 76 T.C.M. (CCH) 62, 62-64 (1998), were the sole shareholders of a family corporation carrying on a long-standing family business. The decedent became terminally ill and wished to ensure that control of the family business was transferred to his sons. The decedent's wife transferred a small percent of her voting shares to the sons and then the four family shareholders (who were also directors and officers) approved a recapitalization agreement creating two new classes of common stock, voting and nonvoting. Under the agreement, the decedent and his wife each exchanged their 50 percent of the corporation's outstanding voting stock for an equal number of shares of nonvoting Class B stock. The old stock received by the corporation was cancelled. The two sons exchanged their shares of stock for an equal number of Class A voting stock. The decedent's wife then transferred her nonvoting stock by gift to the decedent. After the transactions, the two sons had 100 percent of the voting stock, and the decedent had 100 percent of the nonvoting stock.

The court rejected the argument that the decedent made no gift in connection with the recapitalization. Citing Kincaid, and applying section 25.2511-1(h)(1) (B's transfer of property to corporation is gift by B to other individual shareholders to extent of their proportionate interests in corporation) the court held that the decedent and his wife made indirect gifts to their sons, the other shareholders owning voting stock, when they exchanged their voting stock for nonvoting stock .[2] Estate of Bosca, id.

In the present case, Donor reported on gift tax returns that she transferred shares of FC stock by gift to her family members, claimed a combined U percent discount for minority interest and lack of marketability with respect to each block of stock transferred, and further claimed section 2503 annual gift tax exclusions with respect to each gift. The facts as developed indicate no provision in corporate documents setting a par, or liquidation, value for FC stock.

With respect to the gifts to Donor's children on Date 2, the facts appear to indicate that Donor instead made indirect gifts to each child of a proportionate share of the cash and securities transferred just previously into FC. At the age of XX, Donor discussed estate planning, planned family gifts, and the reduction of her estate taxes with her attorney. She subsequently transferred cash and securities worth $ M into FC on its formation, obtained an appraisal recommending a combined U

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[2] The transfers by the decedent's wife were not in issue. The parties stipulated that the value of a share of voting stock before the recapitalization had a greater value than a share of Class B nonvoting stock after the recapitalization, whether valued as part of a 25 percent block of stock or as part of a 50 percent block of stock. The court held that the decedent made a separate indirect gift of 25 percent of the voting stock of the corporation to each of his two sons at recapitalization. The amount of each gift was the amount by which the value of each 25 percent block of voting stock prior to recapitalization exceeded the value of the 25 percent block of nonvoting stock received in exchange by the decedent (i.e., the compensation). See I.R.C. § 2512(b); Treas. Reg. § 2512-8. Estate of Bosca, T.C. Memo. 1998-251.

percent discount for lack of control and marketability with respect to a block of G shares of FC stock, and at the same time made gifts of G shares, or T percent of her FC stock, to each of her children. As discussed above, the corporation conducted no business, and the gifts appear to be part of Donor's testamentary plan. Outside of any liquidation value of her retained FC stock, which the facts as developed indicate has not been set at greater than zero, Donor received no consideration for the transfer of her portfolio to FC because the other shareholders contributed nothing to the corporation in exchange for the stock they received. Cf. Estate of Reichardt v. Commissioner, 114 T.C. 144, 155 (2000). With respect to the initial transfers to Donor's children, therefore, looking at the overall economic effect, as required by Sather and Kincaid, it appears that Donor in substance made indirect gifts to each of her children at the formation of the corporation, the amount of which is determined by each child's proportionate share of corporate stock received (i.e.,T percent).

With respect to the gifts to Donor's children, grandchildren, and great-grandchildren on Dates 3, 4, and 6, it could be argued that these transfers merely are part of Donor's overall testamentary, estate-tax reduction plan and as such similarly are indirect gifts in the amount of the enhancement in value of each shareholders' interest in the corporation (i.e., that proportionate share of the value of the underlying assets). This argument is difficult to make persuasively, however, where a corporation has been in existence for many years and where the parties have respected the corporate form throughout that time. Further factual development as discussed in Issue 1 should be undertaken before it is determined whether to advance the indirect gift position with respect to the gifts on Dates 3, 4, and 6.

B. Second Inquiry - Determining the value of the property transferred

Once the property transferred has been identified, it is necessary to determine the value of the property interest transferred by applying the appropriate valuation standard. Section 2033 provides that the value of a decedent's gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of death. Section 2512 provides that the amount of a gift is the value of the property transferred by gift as of the date of the gift. See also Treas. Reg. §§ 20.2031-1 and 25.2512-1. The gift tax reaches not only those transfers that comport with common law notions of donative transfers, but is imposed on sales, exchanges, or other transfers of property for which the transferor receives less than adequate consideration in money or money's worth. Treas. Reg. § 25.2512-8. In such cases, the value of the gift is the amount by which the value of the property exceeds the consideration received. I.R.C. § 2512(b); Treas. Reg. § 25.2512-8.

As a general rule, in either a gift tax or an estate tax case, value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Treas. Reg. §§ 20.2031-1 and 25.2512-1. This objective test requires property to be valued from the viewpoint of a hypothetical buyer and seller, each of whom would seek to maximize his or her profit from any transaction involving the property. See United States v. Cartwright, 411 U.S. 546, 551 (1973); Estate of Watts v. Commissioner, 823 F.2d 483, 486 (11th Cir. 1987); Estate of Bright v. United States, 658 F.2d 999, 1005-06 (5th Cir. 1981). In the case of certain intrafamily transfers, however, special valuation rules may apply. Application of both these special valuation rules and the general rule is discussed below.

> Issue 4. Whether, in valuing Donor's gifts to her family members, FC's corporate structure should be disregarded as a restriction on the sale or use of the assets contributed by Donor to the corporation, pursuant to section 2703(a)(2).

Section 2703(a)(2) imposes a special rule for valuing intrafamily transfers of property. Under this section, for both gift and estate tax purposes, the value of "any property" transferred between family members shall be determined without regard to "any restriction on the right to sell or use such property." The regulations track the statutory language in defining the term "restriction" as "[a]ny restriction on the right to sell or use the property." Treas. Reg. § 25.2703-1(a)(2)(ii). A right or restriction subject to the special valuation rule may be contained in partnership agreements, articles of incorporation, or shareholders' agreements, and may be implicit in the capital structure of an entity. Treas. Reg. § 25.2703-1(a)(3).

Section 2703(a)(2) does not apply if the restriction on the right to sell or use transferred property independently satisfies each of the three safe harbor requirements set forth in section 2703(b). Taxpayers claiming exemption from application of section 2703(a)(2) must establish that: (1) the restriction is a bona fide business arrangement; (2) the restriction is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and, (3) the terms of the restriction are comparable to similar arrangements entered into by persons in an arm's length transaction. I.R.C. §S 2703(b); Treas. Reg. § 25.2703-1(b)(1), (2).

Section 2703 was enacted as part of a new Chapter 14 in 1990 to more effectively address estate planning techniques that produce valuation distortions by reducing the value of property for estate and gift tax purposes, but have no practical effect on the actual value of the property in the hands of the transferees. Omnibus Budget and Reconciliation Act of 1990, Sen. Amend. to H.R. 5835 (hereinafter "OBRA Sen. Amend."), 101st Cong., 2d Sess., 136 Cong. Rec. at S15680 (Oct. 18, 1990); Estate Freezes- Hearing on "Discussion Draft" Before the Subcomm. On Energy and Agricultural Taxation and Subcomm on Taxation and Debt Management ("Senate Hearing"), 101st Cong., 2d Sess. at 7 (June 27, 1990) (statement of Michael Graetz, Dep. Ass't Treas. Secr. for Tax Policy); Hearing on the "Discussion Draft" Relating to Estate Valuation Freezes Before the Comm. on Ways and Means ("House Hearing"), 101st Cong., 2d Sess. at 37 (April 24, 1990) (statement of Kenneth W. Gideon, Ass't Treas. Secr. for Tax Policy).

Although Congress believed that, in legitimate circumstances, the long-standing rules recognizing valuation discounts attendant upon fractional ownership or lack of marketability of partnership or corporate interests were appropriate, Congress was also aware that use of the partnership or corporate format in intrafamily transactions provides opportunities to manipulate the normal valuation rules in an abusive manner. See OBRA Sen. Amend. at 15681-83. The use of certain rights, lapses or restrictions in intrafamily transfers were, therefore, considered abusive despite the fact that appraisers normally took them into account in valuing transferred property because their presence would decrease the purchase price in a sale between willing buyers and sellers in legitimate business arrangements.

Specifically, Congress designed section 2703 to address the retention of discretionary rights by the older generation that were not likely to be exercised in a family context, and the related problem that arose where restrictions on the sale or use of property, such as those found in buy-sell agreements, were used. The improper use of such restrictions in intrafamily transfers "had the potential for suppressing the value of a business interest for transfer tax purposes." House Hearing at 43; Joint Hearing: Proposals Relating to Federal Transfer Tax Consequences of Estate Freezes Before the Subcomm. On Energy and Agricultural Taxation and Subcomm. On Taxation and Debt Management (hereinafter "Joint Hearing"), 101st Cong., 2d Sess. at 18 (Jt. Comm. on Taxation Print, June 22, 1990) ("Undervaluation also may result from the failure to value correctly restrictions or options to buy property.") "It is the transfer tax avoidance due to the discontinuity between the assumptions used in valuing the transferred interests and the likely behavior of family members that [is considered] abusive." Senate Hearing at 7; House Hearing at 37-40.

In Estate of Church v. United States, 2000-1 USTC (CCH) 60,369 (W.D. Tex. 2000), appeal pending (No. 00-50386, 5th Cir.), and Estate of Strangi, discussed above, the courts recently concluded that a family limited partnership was not itself a "restriction on the right to sell or use" property transferred by a decedent to the partnership. In Estate of Strangi, the court stated that the basis for its opinion was that "neither the language of [section 2703(a)(2)] nor the language of the regulations" thereunder supports the position that the term "property" as used in section 2703(a)(2) refers to the underlying assets contributed to the entity by the decedent and that the partnership form is the restriction that must be disregarded. Estate of Strangi, 115 T.C. at 488-89. Because it held that section 2703(a)(2) did not apply, the Tax Court in Estate of Strangi did not address whether the taxpayer satisfied the safe harbor requirements of section 2703(b). In Estate of Church, the district court determined that all three requirements of section 2703(b) had been satisfied. The section 2703 special valuation rule, therefore, would not in any event have applied in that case.

Although the term "property" is not defined in either section 2703, its regulations, or any other provision of Chapter 14, the courts in Estate of Church and Estate of Strangi did not reference the statute's legislative history. Reference to the legislative history, however, is critical to the proper analysis of the term "property" as used in section 2703(a)(2).

The original bills containing the section 2703 provisions listed certain specific "rights with respect to property" that must be disregarded for valuation purposes, and did not reference "restriction[s] on the sale or use of property." House Hearing at 17 ("Discussion Draft"); H. R. 5425, 101st Cong., 2d Sess. at 23 (Aug. 1, 1990) (stating also that "[i]f the capital structure of any partnership or corporation (or other arrangement) has substantially the same effect as a" listed right that must be disregarded, "such capital structure (or other arrangement) shall be treated as such a right.") In section 2703 as enacted, Congress replaced "right[s] with respect to property" that must be disregarded with "[a]ny restriction on the right to sell or use such property" in section 2703(a)(2). These changes were intended to broaden as widely as possible the category of rights or restrictions with respect to property to which section 2703(a)(2) applies.

> The bill provides that the value of property for transfer tax purposes is determined without regard to any option, agreement or other right to acquire or use the property at less than fair market value or any restriction on the right to sell or use such property, unless the option, agreement, right or restriction meets three requirements. <u>These requirements apply to any restriction, however created</u>. For example, they apply to restrictions implicit in the capital structure of the partnership or contained in a partnership agreement, articles of incorporation, or corporate bylaws or a shareholders' agreement.

OBRA Sen. Amend. at 15683 (emphasis added).

The key all-inclusive phrase, "any restriction, however created," is broad enough to include the restrictions inherent in the entity form. Thus, we believe Congress recognized that the replacement of outright or fee ownership of property (such as real estate, stocks, bonds, life insurance policies, or operating business assets) with ownership of an interest in a partnership or corporation to which such assets have been transferred automatically imposes restrictions on the right to sell or use such assets. The potential for valuation abuses due to "the discontinuity between the assumptions used in valuing the transferred interests and the likely behavior of family members" is great in such circumstances. In intrafamily situations, the potential for valuation abuse is so great that any discounts that otherwise might be applicable to family partnership or family corporation interests automatically must be disregarded for transfer tax purposes pursuant to section 2703(a)(2) unless the taxpayer establishes that the entity should be recognized and that the three requirements of section 2703(b) have been satisfied. The regulations track the language in the legislative history, supporting this position. Thus, the section 2703(a)(2) applies to "any restriction, however created," including rights or restrictions that "may be implicit in the capital structure of an entity." Treas. Reg. § 25.2703-1 (a)(3).

We also note that, in the absence of a bona fide business arrangement, the term "property" in section 2703(a)(2) must refer to the underlying assets of the family partnership or family corporation, not the transferor's partnership or corporate interest. The restrictions created by partnership agreements, articles of incorporation and shareholders' agreements commonly utilized in these arrangements distort the value of the property subject to the transfer (the underlying assets transferred to the entity). Claimed discounts from the value of the assets reflect that distortion. Applying the term "property" to the partnership or corporate interests, as opposed to the underlying transferred assets, circumvents Congress' purpose and intent in enacting Chapter 14. Family limited partnership or family corporation tax shelters are built upon distortions in value created by transferring property into entities crafted to reduce transfer taxes. This temporary artificial distortion of the value passing to the natural objects of a transferor's bounty is the type of abuse that chapter 14 was designed to prevent.

In this case, the type of facts discussed above in Issues 1 and 3 pertaining to lack of economic substance and indirect gifts would also tend to establish that the section 2703(b) requirements for relief from the application of section 2703(a)(2) have not been satisfied. For instance, the facts as developed indicate that Donor's gifts were testamentary in nature. See Estate of Gloeckner v. Commissioner, 152 F.3d 208, 215-16 (2d Cir. 1998) (family relationship among shareholders combined with poor health and age of family member forming closely-held corporation may establish that restrictive shareholders' agreement is testamentary in nature); accord, St. Louis County Bank v. United States, 828 F.2d 177, 1207, 1210-11 (3d Cir. 1987). Because the transfers were completely donative in nature, moreover, Donor received no compensation in exchange and no arm's length negotiations took place between Donor and the donees (her family members). See Treas. Reg. § 25.2703-1 (b)(4) (negotiation between the parties and the adequacy of consideration are factors to be considered in determining comparability to similar arrangements entered into by persons in an arm's length transaction). Accordingly, the requirements that the right or restriction, i.e., the corporation, must not be part of a plan to transfer property to the natural objects of Donor's bounty and that the restriction must be of a type comparable to those entered into by unrelated third parties in arms' length transactions have not been met, and the special valuation rule of section 2703(a)(2) automatically applies. See I.R.C. § 2703(b)(1), (2). (3); Treas. Reg. § 25.2703-1(b) (each section 2703(b) requirement must be independently satisfied; if any is not satisfied, the taxpayer does not qualify for exception from application of the special valuation rule).

Because section 2703(a)(2) applies to disregard FC's corporate form, if further factual development as recommended under Issue 1 confirms that Donor has not satisfied the section 2703(b) "safe harbor" requirements for exception to the statute's application, no discounts from the fair market value of each proportionate gift of FC's underlying cash and securities should be allowed. [redacted]

[redacted]

Issue 5. Whether restrictions in FC documents must be disregarded when valuing FC stock transferred in intrafamily transactions pursuant to section 2703(a)(2).

Even assuming FC's corporate form is respected for purposes of section 2703(a), the application of the section 2703(a)(2) special valuation rule may still be in issue. As discussed above in Issue 4, pursuant to the plain language of section 2703(a)(2), the regulations thereunder, and the legislative history, restrictions on a family transferee's right to sell or use his or her family partnership interest or corporate stock contained in articles of incorporation, partnership agreements, or corporate shareholders' agreements must be disregarded for gift and estate tax valuation purposes unless the section 2703(b) requirements are satisfied. See Treas. Reg. § 25.2703-1(a)(3); OBRA Sen. Amend. at 15683.

If further factual development confirms that Donor has not satisfied the section 2703(b) requirements for safe harbor relief as discussed in Issue 4, and if such further factual development indicates the existence of restrictions on the donee shareholders' right to sell or use their FC stock in any corporate documents or agreements, section 2703(a)(2) automatically would apply to disregard the restriction when valuing the transferred stock.

Moreover, even if no documents containing restrictions on sale or use of FC stock exist, the FC shareholders would be subject to any such restrictions that might exist under the law of State 2. Because both the regulations and the legislative history provide that "any restriction, however created" must be disregarded under the special valuation rule, if further factual development indicates the presence of such restrictions under the law of State 2, they must be disregarded when valuing Donor's gifts of FC stock to her family members. In either case, this would require the taxpayer to obtain an appraisal specifically addressing restrictions on the right to sell or use the property, and may necessitate that the Service also obtain a section 2703 appraisal.

Issue 6. Whether, pursuant to section 2704(b), restrictions on liquidation must be disregarded when valuing gifts of FC stock.

The special valuation rule of section 2704(b) provides that where a partnership or corporate interest is transferred to (or for the benefit of) a member of the transferor's family, and immediately before the transfer the transferor and his family hold control of the entity, any "applicable restrictions" are disregarded when valuing the transferred interest. I.R.C. § 2704(b)(1). The term "applicable restriction" is defined as any restriction that effectively limits the ability of the partnership or corporation to liquidate, and which is removable, in whole or in part, by the transferor or any member of the transferor's family. I.R.C. § 2704(b)(2). The regulations further define an "applicable restriction" as a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." Treas. Reg. § 25.2704-2(b). Section 2704(b)(3)(B) provides that the term "applicable restriction" does not include "any restriction imposed, or required to be imposed, by any Federal or State law."

In Kerr v. Commissioner, 113 T.C. 449 (1999), appeal pending, No. 00-60903 (5th Cir. 2001), the Tax Court held that restrictions on the right of a limited partner to withdraw from, or liquidate his particular interest in, a limited partnership is not an "applicable restriction" that must be disregarded for valuation purposes within the meaning of Treas. Reg. § 25.2704-2(b). In two recent cases, the Tax Court followed its reasoning in Kerr. See Estate of Jones v. Commissioner, 116 T.C. No. 11, 1001 U.S. Tax Ct. LEXIS 11 (March 6, 2001); Estate of Harper v. Commissioner, T.C. Memo. 2000-202 (2000). No circuit court has yet ruled on this issue.

Notwithstanding the Tax Court's decisions, the plain language of Treas. Reg. § 25.2704-2(b) provides that an applicable restriction "is a limitation on the ability to liquidate the entity (in whole or in part)." This point is illustrated by Treas. Reg. § 25.2704-2(d), Example 5, in which D owns 60 percent of the preferred stock and 70 percent of the common stock of Corporation. The remaining stock is owned by unrelated individuals. D transfers the common stock to D's child in a transfer that is subject to section 2701. The restriction on D's right to liquidate his remaining preferred stock is an applicable restriction that is disregarded in determining the amount of the gift under section 2701, i.e., a restriction on the ability to liquidate the entity "in part." We believe, therefore, that the argument that restrictions on a partner's or shareholder's right to liquidate his or her entire interest by withdrawing from the partnership, or by selling all of his or her stock, are restrictions that must be disregarded under section 2704(b) continues to have force and validity.
In the present case, the facts as developed indicate that no FC document contains any mention of rights, limitations on rights, or restrictions on rights of the shareholders to sell all of their own stock or to liquidate the corporation. Absent such provisions, the section 2704 regulations require that transferred FC stock must be valued as though the liquidation rights with respect to the transferred interests are determined under the applicable state law. See Treas. Reg. § 25.2704-2(c). Because section 2704(b)(3)(B) excepts from the definition of an applicable restriction any restriction imposed by any federal or state law, unless further factual development shows that liquidation provisions exist in an FC document and that such provisions are more restrictive than the pertinent law of State 2, section 2704's special valuation rule is not applicable. Should you need additional assistance once you have developed this issue, please contact our office.

Issue 7. Whether, in the alternative, Donor is entitled to the claimed combined discount for minority interest and lack of marketability with respect to all transfers of FC stock to her family.

As an alternative, or in addition to the arguments discussed above, if the form of Donor's transactions is respected, it appears that the discount claimed with respect to each of the gifts of FC stock is excessive. Each gift is to be valued separately and is not aggregated with other gifts that might have been made at the same time. See Rev. Rul. 93-12, 1993-1 C.B. 202. FC's assets consist solely of cash and readily-marketable municipal and federal governmental debt obligations. Donor has obtained two expert appraisals, upon which she relies in her claimed discounts. The first, upon which her gift tax returns were based, recommended a combined U percent discount. This report has since been disavowed, and instead a Donor now relies on an expert report recommending a combined discount for minority interest and lack of marketability of V percent. Establishing the proper discount will require the Service to acquire an expert appraisal. We recommend the following considerations be presented to the expert appraiser:

(1) Reduction of Minority Interest/Lack of Control Discounts: A family corporation holding liquid assets may be analogous to a trust for valuation purposes, because in some cases the primary purpose of both is to hold assets for protection and investment for ultimate distribution to the beneficiaries/entity interest holders. The facts may show that the relationship between the family member in control of the corporation or family partnership and the other family interest holders is analogous to the relationship between a trust's beneficiaries and its trustees. In such a case, a reduction in the discount for minority interest or lack of control may be indicated.

(2) Closed-end Mutual Fund Analogy: Family partnerships and family corporations holding readily marketable assets are most comparable publicly traded closed-end mutual funds. Staff of the Joint Committee on Taxation, 105th Cong., 2nd Sess. Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal 176, 178-79 (Jt. Comm. Print, February 24, 1998). Like a limited partner or closely-held corporate stockholder, a closed-end mutual fund investor owns an interest in a pool of liquid assets held for investment; the investor has no control over management of assets or the nature of the investments. Closed-end mutual funds generally trade at a discount from net asset value of 4-12 percent, a discount which is deemed sufficient by the public markets to reflect the disadvantages of a minority interest. Interests in family partnerships and family corporations usually are not readily marketable, as is the case with mutual funds. Thus, it may be necessary to concede a discount for lack of marketability, based on the facts and opinion of a qualified expert.

(3) Publicly Traded Partnerships as Comparables: The appropriate willing buyer/willing seller price comparison would be the price the promoter charges, and the investor pays, when units are initially sold to the public, rather than the price at which the units are later sold by the investor in the secondary market. Generally, on the initial offering, the investor is willing to pay full value for the partnership units (i.e., 100% of the net asset value represented by the partnership units purchased). Arguably, the family member receiving interests in a newly formed

family limited partnership is in no different position from that of an investor purchasing publicly traded units in the initial public offering.

(4) Elements of Value: (a) Business purpose factors should enhance the value of the partnership interests, thereby offsetting some of the discounts claimed. Restrictions on the other partners' ability to withdraw from the partnership or transfer their interests arguably enhance the value of the subject partnership interest. These restrictions ensure that the underlying partnership assets will remain intact, and that the partnership will have a long and stable existence; (b) In applying the willing buyer/willing seller test, the willing seller would not sell his or her interest at a substantially discounted value. See Estate of Mandelbaum v. Commissioner, T.C. Memo 1995-255, aff'd, 91 F.3d 124 (3rd Cir. 1996). ("[T]he test of fair market value rests on the concept of a hypothetical willing buyer and a hypothetical willing seller. Ignoring the views of the willing seller is contrary to this well-established test.") The regulatory hypothetical seller is under no compulsion to sell. Treas. Reg. § 20.2031-1(b). The courts, therefore, have often agreed that an individual who just transferred liquid assets of significant value to a family partnership or corporation and is under no compulsion to sell that new interest would not agree to sell that interest at a price significantly less than the value of the assets he transferred to the partnership.

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If you have any further questions or require additional assistance, please contact our office.

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